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Decision 01-12-015 December 11, 2001

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company (U 902-E) for an Order Implementing Assembly Bill 265.	Application 00-10-045 (Filed October 24, 2000)
Application of San Diego Gas & Electric Company (U 902-E) for Authority to Implement an Electric Rate Surcharge to Manage the Balance in the Energy Rate Ceiling Revenue Shortfall Account.	Application 01-01-044 (Filed January 24, 2001)

OPINION ON PROPOSED COST RECOVERY MECHANISM FOR UTILITY-RETAINED GENERATION

1. Summary

On June 18, 2001, San Diego Gas & Electric Company (SDG&E), its parent company Sempra Energy, and the Department of Water Resources (DWR) entered into a Memorandum of Understanding (MOU) regarding the provision of electricity to SDG&E's customers.[1] By motion filed in this consolidated proceeding on July 16, 2001, SDG&E requests that the Commission issue several "Implementing Decisions" related to the MOU. This decision responds to one

[1] Sempra Energy entered into the MOU only as to certain sections thereof. DWR entered into the MOU separately and apart from its powers and responsibilities with respect to the State Water Resources Development System.

aspect of the motion, i.e., SDG&E's request that the Commission adopt a utility-retained generation (URG) cost recovery mechanism that "… ensures that SDG&E collects revenue sufficient to cover its costs associated with its URG."[2] (July 16 Motion, p. 7, Item c.) This decision does not resolve implementation of the MOU as a whole.

We determine that SDG&E's existing ratemaking mechanisms for URG cost recovery are adequate on an interim basis, pending a decision on an application that we direct SDG&E to file. We also clarify that continuing existing ratemaking mechanisms for URG on an interim basis does not guarantee complete recovery of SDG&E's incurred URG costs without meaningful opportunity for this Commission to determine whether costs that are passed on to ratepayers are reasonably incurred. We direct SDG&E to make a proposal for a permanent URG cost recovery mechanism which may include a provision for eliminating traditional after-the-fact reasonableness reviews, provided that such mechanism reasonably assures that ratepayers are protected against paying for unreasonable costs.

2. Background

By ruling issued on July 23, 2001, interested parties were allowed to file comments on SDG&E's July 16 motion for implementation of the MOU. Parties were directed to file such comments by July 27, 2001. Comments were filed by the Office of Ratepayer Advocates (ORA), the Department of the Navy on behalf of itself and all Federal Executive Agencies (FEA), the California Farm Bureau Federation (CFBF), and jointly by the Utility Consumers' Action Network

[2] SDG&E defines its URG as its generation assets and all energy, capacity, ancillary services, and any combination thereof, to which SDG&E has a contractual right.

(UCAN), Aglet Consumer Alliance (Aglet), and The Utility Reform Network (TURN).

An Assigned Commissioner's Ruling (ACR) issued on August 2, 2001 established a schedule that would allow the Commission to consider the individual components of the MOU as quickly as reasonably practicable, and in any event prior to the end of the year. The ruling also set an oral argument, held in San Diego on August 16, 2001, to address the merits of the MOU. A public participation hearing on the MOU was held on the same day. This decision is issued pursuant to the August 2, ruling, and is based on the July 16 motion, the comments filed pursuant to the July 23 ruling, and the August 16 oral argument and public participation hearing.

On October 30, 2001 the Administrative Law Judge (ALJ) issued a draft decision approving an interim URG cost recovery mechanism drawn from elements of SDG&E's Utility-Retained Generation Cost Adjustment Mechanism (URGCAM) balancing account proposal. The draft decision also directed SDG&E to file an application for a longer-term URG cost recovery mechanism. SDG&E and ORA filed comments on the draft decision.

In its comments, SDG&E stated that due to recent events and changed circumstances, the URGCAM approach is not needed on an interim basis unless the Commission rejects tariff changes under consideration in SDG&E's Advice Letter 1365-E. SDG&E supports the development of a permanent URG cost recovery mechanism and it agrees to file an application for such a mechanism.

On November 8, 2001 the ALJ issued a ruling providing for reply comments after determining that SDG&E's revised proposal represented a fundamentally different approach to URG cost recovery. SDG&E and ORA filed reply comments.

On October 10, 2001 ORA, FEA, CFBF, Aglet, TURN, and UCAN (collectively, Consumers) filed a motion for adoption of a stipulation joined by each of them. The Consumers' stipulation is presented as a means of resolving several ratemaking issues before the Commission and represents an alternative to the MOU. By ruling issued on November 16, 2001, the Assigned Commissioner designated the stipulation a Joint Proposal and provided for comments and replies thereon. This decision does not address the Joint Proposal, which remains pending before the Commission for review and analysis based on the comments and replies.

3. The Need for a URG Cost Recovery Mechanism

SDG&E states that its proposed URG mechanism is offered in consideration of its commitment of its URG to cost-based ratemaking for SDG&E's bundled service customers,[3] and its commitment not to seek authority to sell such assets through December 31, 2010.[4] However, with respect to

[3] SDG&E believes that its URG should be allocated entirely to "AB 265 customers," *i.e.*, residential, small commercial, and street lighting customers. However, in D.01-09-059 we decided to continue with our usual practice of applying URG to all customer classes, and we do not revisit this issue here. We understand SDG&E's reference to bundled service customers to mean all electric customers, regardless of size or assigned tariff schedule, that do not take direct access service. Bundled service customers are not synonymous with AB 265 customers.

[4] SDG&E states that these URG commitments are subject to adoption of certain Implementing Decisions described in the MOU: (a) Commission approval of the SDG&E/ORA settlement of the procurement reasonableness review in A.00-10-008; (b) Commission execution of a settlement of claims in SDG&E's Writ of Review regarding certain intermediate-term contracts; (c) Commission approval of the proposed URG cost recovery mechanism; and (d) Commission approval of SDG&E's petition for modification in A.93-12-025/I.94-02-002 in which SDG&E requests approval of the MOU's provisions with respect to its interest in the San Onofre Nuclear Generating Station (SONGS). We wish to emphasize that to the extent that SDG&E's

Footnote continued on next page

utility-owned generation assets through the year 2005, there is another and more compelling consideration that leads us to conclude that we should adopt a ratemaking mechanism for SDG&E's URG. Pub. Util. Code § 377, as amended by Assembly Bill (AB) 6 of the first Extraordinary Session of 2001 (Stats. 2001, Ch. 2; hereinafter, referred to as ABX1 6), requires the following:

> The commission shall continue to regulate the facilities for the generation of electricity owned by any public utility prior to January 1, 1997, that are subject to commission regulation until the owner of those facilities has applied to the commission to dispose of those facilities and has been authorized by the commission under Section 851 to undertake that disposal. Notwithstanding any other provision of law, no facility for the generation of electricity owned by a public utility may be disposed of prior to January 1, 2006. The commission shall ensure that public utility generation assets remain dedicated to service for the benefit of California ratepayers.

In view of the foregoing, and in particular the requirement of § 377 that we "shall ensure that public utility generation assets remain dedicated to service for the benefit of California ratepayers," it is incumbent upon the Commission to provide for SDG&E's continued ability to dedicate and operate its URG to service for ratepayers' benefit. We intend to apply cost-based ratemaking to all of SDG&E's retained generation assets (*see* footnote 2, *supra*), which we believe is consistent with ABX1 6. This in turn requires that we ensure the existence of an appropriate ratemaking mechanism with respect to SDG&E's URG.

4. Adopted Approach

As several parties have pointed out, there has not been an adequate opportunity in this proceeding for full and fair consideration of SDG&E's proposed

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URG commitments are already mandated as a matter of law, SDG&E cannot make such commitments conditional, subject to decisions that it has asked us to make.

URG cost recovery mechanism or possible alternative mechanisms. Among other things, we believe it is necessary to more closely coordinate development of the mechanism for SDG&E's URG cost recovery with current, related proceedings regarding SDG&E's interest in SONGS (A.93-12-025/I.94-02-002), SDG&E's URG revenue requirement (A.00-11-038, et al.), and our rulemaking proceeding for cost recovery for procurement of net short energy requirements (R.01-10-024). Accordingly, we find that it is appropriate to provide a forum for full and fair consideration of a URG cost recovery mechanism.

SDG&E contends that its proposal for assured, complete URG cost recovery is justified in view of its commitments (1) to provide its URG under cost-based ratemaking to its bundled service customers and (2) to not seek authority to sell such assets through December 31, 2010. SDG&E asserts that these URG commitments represent a substantial and valuable benefit to its customers that justifies the particular cost recovery plan it has proposed. Again, there has not been adequate opportunity to consider the value to ratepayers of SDG&E's URG commitments, or to weigh such value against particular program elements proposed by SDG&E that may not benefit ratepayers. Thus, on the limited record before us, we cannot accept SDG&E's proposition that "[i]t is clearly reasonable for SDG&E, in exchange [for its URG commitments], to be entitled to collect revenues from its customers sufficient to recover completely all its costs associated with that committed URG."

As indicated earlier, this decision does not consider the MOU as a whole. Accordingly, for purposes of this decision, we explicitly do not accept SDG&E's assertion that ratepayer benefits are "enhanced greatly" by the fact that approval of SDG&E's proposal for URG cost recovery would satisfy one of the MOU's several provisions for Implementing Decisions.

In response to the URGCAM proposal in the draft decision, SDG&E noted that its currently authorized cost recovery mechanism for URG, as recently modified, provides for balancing account treatment. In D.01-09-059 the Commission directed SDG&E to establish a balancing account to ensure that the utility recovers neither more nor less than its imputed utility rate. SDG&E believes that this balancing account, as reflected in tariff language that it has filed with its Advice Letter 1365-E, obviates the need for an interim URGCAM balancing account mechanism. SDG&E filed that advice letter on September 27, 2001 to implement D.01-09-059. SDG&E notes that its tariff language provides that recovery of any undercollection will be determined in a future proceeding that will address URG cost recovery.

On an interim basis, we agree that this existing mechanism is adequate for timely recovery of URG costs and, subject to clarification as discussed in the following section, for ratepayer protection. We therefore determine that it is not necessary to establish an alternative interim mechanism at this time. Continuation of the current balancing account for imputed and effective utility rates, as ordered in D.01-09-059, is a simpler approach to interim URG cost recovery. It will allow the parties and the Commission to focus their efforts on developing a more permanent URG cost recovery mechanism without having to also deal with development of the details of an alternative interim mechanism that would only be effective for a period of one year or less.

In its comments on the draft decision, SDG&E in effect conditions its proposal to continue recovering URG costs through its currently authorized balancing account, in lieu of the URGCAM, upon Advice Letter 1365-E becoming effective. However, it is the Commission's adoption of an accounting mechanism in D.01-09-059, not the implementing advice letter filing, that makes

possible our decision today to not adopt the interim URGCAM approach. Therefore, we do not link today's decision to the disposition of Advice Letter 1365-E.

We direct SDG&E to file an application for a more permanent URG cost recovery mechanism that would continue, modify, or replace the current mechanism. SDG&E should file this application within 30 days of the effective date of this decision. The application will provide SDG&E an opportunity to better explain, update, and refine its URG cost recovery proposal in light of the concerns we discuss herein as well as the latest developments in the unsettled electric industry. It will also provide all parties an opportunity to review SDG&E's proposal and offer for our consideration alternative proposals for URG cost recovery. SDG&E's application should demonstrate how its proposed URG mechanism interacts with its net short cost recovery mechanism. We intend to process this application in a timely fashion so that implementation of the mechanism can be coordinated with the implementation of any procurement cost recovery plan adopted in R.01-10-024.[5]

5. Reasonableness Review

Under SDG&E's July 16, 2001 proposal, the costs of all URG in existence as of that date and ISO costs and costs for ancillary service incurred at any time

[5] In its comments on the draft decision, SDG&E recommends that the Commission either (1) order that SDG&E's URG and non-URG procurement plans be consolidated in a single filing or (2) order that the application for a long term URG cost recovery mechanism be consolidated with the statewide procurement proceeding. While the topics are linked, and as noted earlier there is a need to coordinate development of a URG mechanism with related proceedings, we do not want to jeopardize the timely processing of R.01-10-024. Therefore, we do not adopt either of SDG&E's procedural recommendations at this time.

would be deemed *per se* reasonable, and no reasonableness reviews would be required or allowed for any of those costs. In this section we state and explain our intentions with respect to reasonableness review, both for interim URG cost recovery and the permanent mechanism. By electing to continue in effect SDG&E's currently authorized balancing account mechanism for purposes of URG cost recovery, we do not waive our right to review the reasonableness of URG costs booked to the applicable balancing accounts.

As ORA has pointed out, SDG&E's proposal for reasonableness reviews is unclear as to scope. Among other things, we are uncertain as to whether SDG&E is proposing that all past, current, and future costs for URG in existence as of July 16, 2001 would be exempt from reasonableness review, or that URG costs as of July 16 would be exempt.

As a matter of regulatory policy, we are not persuaded on the basis of this limited record to forgo reasonableness reviews in connection with SDG&E's proposal for recorded cost ratemaking. SDG&E states that it seeks approval of a cost recovery mechanism that is in accordance with the principles of cost-based ratemaking as applied in California, but it fails to explain how an exemption from reasonableness review comports with those principles. As the Commission stated in D.96-12-088, in the Electric Restructuring proceeding, as long as fuel procurement practices are undertaken in a regulated regime, reasonableness reviews would be the quid pro quo of balancing account treatment.[6] (70 CPUC

[6] *See also* D.97-12-096, p. 24, in which the Commission adopted a ratemaking mechanism for PG&E's hydroelectric and geothermal generation: "We continue to believe that reasonableness reviews are the *quid pro quo* of balancing account treatment, even if the balancing account in question has a new name or serves a somewhat different function." (77 CPUC 2d 738, 751.)

2d 497, 517.) We note that the MOU itself states that nothing therein "shall prohibit the [Commission] from employing ratemaking and regulatory techniques, methods and standards that have been historically used and may be used or implemented in the regulation of public utilities." (MOU, p. 2.)

We recognize that traditional after-the-fact reasonableness reviews are often difficult and contested proceedings. We have found that utilities seeking to be excused from reasonableness reviews (and the associated risk of disallowance of expenses found to be unreasonably incurred) object to the fact that in such proceedings, their adversaries bring known, historical information to the analysis of actions that management undertook in real time in reliance on forecasts. Utilities claim that being held accountable for the reasonableness of their actions on the basis of "20/20 hindsight" is unfair to them and to their shareholders. There is also a broader concern that balancing account ratemaking combined with retrospective reasonableness reviews creates inappropriate incentives for utility managers to perform in ways that may not promote regulatory objectives.

Based upon such concerns, in the past decade we have sought alternative forms of ratemaking that do not require this type of proceeding. For example, nine years ago SDG&E applied for approval of a form of incentive regulation that would, among other things, eliminate traditional reasonableness reviews for gas procurement and electric generation and dispatch. In conditionally approving SDG&E's request, the Commission observed the following with respect to the then-existing Energy Cost Adjustment Clause (ECAC) mechanism:

> "Under the Commission's current regulatory program, SDG&E receives balancing account treatment for all generation, dispatch and purchased power costs reviewed during the ECAC proceeding. These include fuel and fuel-related costs for electric operations. 'Balancing account treatment' means in essence that SDG&E's actual expenses are recorded, and any overcollections or undercollections

> resulting from differences between billed amounts and actual expenses are reflected in rates, subject to reasonableness review. [Footnote omitted.]"

> "A long-standing criticism of balancing accounts and their correlative reasonableness reviews is that they do not provide the utility with any positive incentive to control costs subject to such treatment. The utility has only a negative incentive, viz., to perform in a manner that minimizes the potential for disallowance." (D.93-06-092; 50 CPUC 2d 185, 192.)

After making these observations, the Commission approved a generation and dispatch ratemaking mechanism that limited the scope of reasonableness reviews for SDG&E. It did so by providing for review of ECAC costs when recorded costs varied from the forecast by more than 6%. It also provided for "reasonableness assessment letters" in connection with power purchases from QFs and uranium procurement. (Id., 198.)

While we do not suggest that the 1993 experiment for SDG&E's generation and dispatch be simply replicated here, we call this matter to SDG&E's attention with the expectation that the company will draw upon lessons learned from the experiment, and that it will recognize the types of concerns we would need to address before doing away with reasonableness reviews connected with balancing account treatment. As was true in 1993, any departure from the established policy of requiring reasonableness reviews in connection with recorded cost ratemaking should be accompanied by a weighing and balancing

of the risks to utilities and their customers that are associated with such departure.[7]

Findings of Fact

1. Pub. Util. Code § 377, as amended by ABX1 6, prohibits the disposition of facilities for the generation of electricity owned by public utilities prior to January 1, 2006, and it requires this Commission to ensure that public utility generation assets remain dedicated to service for the benefit of California ratepayers.

2. The requirement that this Commission shall provide for SDG&E's continued ability to dedicate and operate its URG to ratepayers' benefit in turn requires that the Commission ensure the existence of an appropriate ratemaking mechanism with respect to SDG&E's URG.

3. There has not been an adequate opportunity in this proceeding for full and fair consideration of SDG&E's proposed URG cost recovery mechanism or possible alternative mechanisms.

[7] SDG&E commits to operate all URG subject to its control in accordance with good utility practices. We do not consider this commitment by SDG&E to be an adequate replacement for reasonableness review. We are confident that SDG&E is capable of developing a proposal that merits our consideration. In this respect, we agree with SDG&E's assertion in its May 21, 2001 response to a motion by Southern California Edison Company in R.94-04-031, *et al.* regarding procurement:" . . . [T]he Commission and SDG&E already have a strong background in developing creative approaches to regulatory oversight of electric procurement activities. As for back as 1993, the Commission established the first electric generation [ratemaking mechanism] for SDG&E as a way of addressing the inefficiencies and ineffectiveness of reasonableness reviews to accomplish regulatory policy." (Response, p. 5.)

4. The balancing account mechanism adopted in D.01-09-059 adequately provides for URG cost recovery on an interim basis, pending adoption of a more permanent URG cost recovery mechanism.

5. The Commission has repeatedly adhered to the policy that reasonableness reviews are the *quid pro quo* of balancing account ratemaking treatment.

Conclusions of Law

1. This decision addresses only SDG&E's request for establishment of a cost recovery mechanism for URG, and does not consider the SDG&E/Sempra/DWR MOU as a whole.

2. The Commission should provide for full and fair consideration of a permanent URG cost recovery mechanism.

3. For purposes of URG cost recovery, the balancing account mechanism adopted in D.01-09-059 should be continued in effect on an interim basis.

4. Any departure from the established policy of requiring reasonableness reviews in connection with recorded cost ratemaking should be accompanied by a weighing and balancing of the risks to utilities and their customers that are associated with such departure.

5. In issuing this decision the Commission does not waive its right to review the reasonableness of SDG&E's recorded URG costs.

6. This order should be effective today.

O R D E R

IT IS ORDERED that:

1. With respect to utility-retained generation (URG) cost recovery, the July 16, 2001 motion of San Diego Gas & Electric Company (SDG&E) is granted to the extent set forth in this decision.

2. Within 30 days of the date of this decision, SDG&E shall file an application for a permanent URG cost recovery mechanism.

3. This proceeding shall remain open.

This order is effective today.

Dated December 11, 2001, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
RICHARD A. BILAS
CARL W. WOOD
GEOFFREY F. BROWN
Commissioners